STATE OF VERMONT
PUBLIC SERVICE BOARD

Docket No. 6120

Tariff filing of Central Vermont Public Service )
Corporation requesting a 12.9% rate increase, to )
take effect July 27, 1998 )

Docket No. 6460

Tariff filing of Central Vermont Public Service )
Corporation requesting a 7.6% rate increase, )
to take effect December 24, 2000 )

# PREFILED TESTIMONY OF
# WILLIAM STEINHURST
# ON BEHALF OF THE
# VERMONT DEPARTMENT OF PUBLIC SERVICE

March 9, 2001

Summary: The purpose of Dr. Steinhurst's testimony is explain what actions the Board may take regarding prudence and used and useful issues in this proceeding and to present the Department's recommendations on those issues and setting rates overall for this case.

Prefiled Testimony
of
William Steinhurst

Q. Please state your name and occupation.

A. My name is William Steinhurst, and I am the Director for Regulated Utility Planning for the Vermont Department of Public Service ("Department", "DPS"). My business address is 112 State Street, Montpelier, Vermont.

Q. Have your previously testified before this Board?

A. Yes. Please see Attachment A, page 4, Exhibit DPS___(WS-1).

Q. Please summarize your relevant educational experience.

A. Please see attached Exhibit DPS___(WS-1).

Q. Please describe your work experience.

A. Please see attached Exhibit DPS___(WS-1).

Q. What is the purpose of your testimony?

A. I begin by summarizing the imprudence damages in the present rate cases from the early lock in of the Hydro Québec-Vermont Joint Owners Contract ("the HQ-VJO Contract" or "the Contract") and conclude that under traditional rate making principles Public Service Board ("PSB" or "Board) may disallow in both dockets the full amount of those damages in the form of power cost disallowances. I then summarize the amount of Contract costs in the two rate cases that is not used and useful and conclude that, to the extent any such costs are not disallowed as imprudent, the Board may order the remainder to be shared between ratepayers

and the Company. I explain how such disallowances and sharing, if ordered, would result in a significant reduction to allowable power costs for Docket 6460 rates effective July 23, 2001, and also support a refund of Docket 6120's temporary rates for the period January 1, 1999, through July 22, 2001.[1]

Next, in the alternative, I consider the possibility that the Board may, instead of power cost disallowances and sharing, order reimposition of its Docket 5701/5724 ROE penalty or of a modified or increased version of that penalty. I explain why such actions would be warranted, given the Company's lack of progress in remedying the power supply portfolio shortcomings for which the penalty was originally imposed and given certain new, additional instances of power supply portfolio mismanagement.

Then, having laid a foundation for a range of very large disallowances or penalties, I explain why the Board should forebear from imposing the full disallowances and penalties that could be applied under traditional rate making, either as power cost adjustments or ROE penalties. Instead, I recommend that the Board fashion a penalty or disallowance that is less than the full amounts it could impose, but as large as can be imposed while maintaining the Company's financial viability with a reasonable safety margin. I concur with DPS witness Ross's preliminary conclusion that the disallowances and penalties imposed should be equivalent to a one-time write down of no more than $25,000,000, subject to the caveats and further discovery he recommends. I also recommend that along with imposing those disallowances or penalties the Board (1) make clear that the ordered disallowances or penalties provide finality as to prudence of the Contract and its management to date; (2) state the

[1]Even if the Board is, for some reason, limited to a return on equity penalty for imprudence, the information presented by the Department regarding the magnitude of potential disallowances under other structures or theories will be useful to the Board for assessing the effectiveness of reimposing that penalty or of imposing a modified or increased return on equity penalty and for considering whether such a penalty should be imposed or reimposed. I believe that in this context a "modification" can include, for example, conversion of the ROE penalty to a write down.

Contract will then be treated *as if* it were used and useful; (3) impose certain conditions including a recapture provision, a service quality and reliability plan, an earnings cap, and flow through of any ice storm arbitration benefits; and (4) structure the disallowances or penalties in such a way that they can be acknowledged for accounting purposes as a one-time write down, if possible, to maximize the certainty that the Company will have access to capital markets.

Q. What prudence disallowance for the HQ-VJO Contract costs would be supported by the facts and traditional rate making in Dockets 6120 and 6460?

A. Since the early lock in has already been found imprudent, the next step in determining the potential disallowance is to identify the costs that would have been incurred in the rate years for these two dockets had CVPS acted prudently. Under traditional rate making, those costs would then be compared to the actual costs of the Company, and any excess disallowed.

In Docket 6120, a tempoarary rate increase of 4.7% was made effective beginning with service rendered January 1, 1999. *Tariff Filing of Central Vermont Public Service Corporation*, Docket No. 6120, Board Order, December 11, 1998, approving Memorandum of Understanding dated October 27, 1998 (the "MOU"). Those temporary rates included some, but not all of the above market costs of the Contract, subject to refund. The potential impact of a prudence disallowance in that proceeding would be to use the Docket 6120 data and the final Contract disallowance (less any provisional Contract disallowance already reflected in the temporary rates) to set final rates for the period January 1, 1999, through the effective date of rates to be set in Docket 6460 (July 23, 2001) and to order a refund of any excess collections.[2]

[2]This analysis is simplified by the fact that the this is the same date an Order is expected in this resumed Docket 6120 proceeding. Had that not been the case, the impact would have been slightly different. For example, suppose that an order were to be issued in Docket 6120 on May 31, 2001, and the effective date of the Docket 6460 rates, whatever they are, remains July 23, 2001. Then rates for Docket 6120 would be set as described above. A refund of the resulting overcollection would be ordered

In Docket 6460, data from that docket and the final Contract disallowance would be used to set final rates for the period beginning July 23, 2001.

Q. What prudence disallowances for the HQ-VJO Contract in Dockets 6120 and 6460 are supported by the facts and traditional rate making?

A. For the Docket 6120 rate year (calendar 1999), the estimated excess power cost due to the Contract was $16.8 million. This disallowance would be used in place of the MOU's provisional prudence disallowance to recalculate the rates for Docket 6120. The total collections that would have taken place under those recalculated rates would be compared to actual collections for the period January 1, 1999, through July 23, 2001, and any overcollection refunded to ratepayers. (Below, I discuss used and useful doctrine and explain that if any lesser amount is disallowed for imprudence in Docket 6120, there may be some remaining above market costs to which a used and useful sharing disallowance ought to be applied. If so, that amount would be added to the prudence disallowance for Docket 6120 before determining the recalculated rates.)

For Docket 6460, the adjusted test year excess power costs for the Contract are estimated at $18 million. This is the amount that would be subject to disallowance in the adjusted test year that would be used to set rates to take effect July 24, 2001. (Again, if any lesser amount is disallowed for imprudence in Docket 6460, there may be some remaining above market costs to which a used and useful sharing disallowance ought to be applied. If so, that amount would be added to the prudence disallowance for Docket 6120 before determining the final rates.)

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for the period January 1, 1999, through May 31, 2001. The new rates for Docket 6120 would take effect June 1, 2001, and remain in place until July 23, 2001, after which the rates set in Docket 6460 would commence effect.

Q. Under traditional rate making, what prudence disallowances would apply to Contract costs in future rate cases after Docket 6460?

A. The structure of the disallowance would be the same. That portion of the adjusted test year power costs attributable to the Contract would be reduced to the price of a prudently acquired power portfolio in the adjusted test year and rates set accordingly. For any future rate cases involving adjusted test years through about 2005, the appropriate prudence disallowance would be determined based on the then applicable costs for the prudent power portfolio developed for this case by DPS witness Chernick. Mr. Chernick also testified that had the Company acted prudently in the early 1990's, it would be in a position of relying on new gas combined cycle units after about 2005, so the costs of such units would apply in any rate years after that point. (To illustrate what such future prudence disallowances may be, we can examine the projection of excess costs that would be expected in rate years after 2005 presented by DPS witness Biewald. If the Board's prudence disallowances prior to 2005 were less than Mr. Chernick's methodology, Mr. Biewald's projections of above market costs would also form a basis for sharing any remainder.)

Q. Why are potential disallowances that would occur in future rate cases relevant to this proceeding?

A. They indicate the magnitude of future disallowances that the Company may need to write down in 2001 if the Board's Order in these proceedings included a full disallowance of the imprudent costs of the Contract. Therefore, the size of these disallowances that would then be expected in future rate cases is relevant to the question of whether the Board should forebear from imposing those full disallowances.

Q. What disallowances are supported by the facts and traditional rate making under the Board's

used and useful doctrine for the HQ-VJO Contract in Dockets 6120 and 6460?

A. Under traditional rate making, the Board may order a sharing between rate payers and the Company of above market costs from the Contract that are not disallowed as imprudent. In the two rate years under consideration here, as testified to by Mr. Chernick, prudent decisions by CVPS in the early 1990's would have resulted in adjusted test year power costs *less* than the market prices actually seen (or projected in the case of the remainder of 2001). Therefore, there would be no additional used and useful disallowance. If the Board were to impose a prudence disallowance assuming a prudent portfolio cost greater than the adjusted test year market costs, then some sharing of the remainder of the above market cost would be in order under the used and useful doctrine. DPS Witness Biewald testifies that the total above market cost of the Contract over its life is $98,000,000 from 2001 forward and an additional $32,000,000 for 1999 and 2000.

In some past cases, the Board has dealt with the sharing under the used and useful standard by starting with an estimate of the present value of above market costs of the Contract over the remainder of its life, deducting the present value of whatever part of those costs would be disallowed due to imprudence in those same years (as if an individual rate case were filed and effective each year), and turning a share of the residual into an annual disallowance.[3] While the specific calculations used in past examples may need to be revisited, the basic structure is reasonable and one the Board may adopt in this instance. If the Board does not disallow all above market costs as imprudent, this structure for a used and useful disallowance would be applicable to computing the refund for Docket 6120 for the period from January 1, 1999, through July 23, 2001, as well as to setting rates going forward for Docket 6460.

[3]That share has typically been 50%.

Q. Is the Board precluded from imposing any of the potential prudence disallowances you have described?

A. That is a legal question. My lay understanding is that issue preclusion is the only form of preclusion that may apply here, and that the Board may clearly reimpose its prior ROE disallowance "as long as CVPS's service is being impaired as a result of the high price of its power." In re Tariff Filing of Central Vermont Public Service Corporation, No. 98-214, slip op. at 18 (Vt. S. Ct, Feb. 9, 2001). If the Board were to apply only a return on equity ("ROE") penalty for imprudence, it would first decide on any modifications to the size penalty or other modifications.[4] Then that penalty would be used to set rates for each of the two dockets and the rest of the process would follow as described above.

Furthermore, it is my understanding that the Court declined to rule on whether the Board may modify or increase that penalty. Op. cit. at 19. In fact, in that part of the Board's 1994 Order on which the Court was commenting when it so declined not only retained for the Board jurisdiction to modify or increase the ROE penalty, but even retained Board jurisdiction to impose an entirely "different remedy to ensure that ratepayers do not bear the financial burden alone."

Thus, it seems clear that the 75 bp penalty may be reimposed, and that the Board is not prevented from modifying or increasing the ROE penalty or even replacing it with a different remedy. Based on these understandings, I believe the Board may impose the full prudence disallowance of costs from the Contract or any lesser disallowance or penalty it determines the facts of the case warrant.

[4] In some orders the phrase rate of return ("ROR") penalty has been used to describe the 75 basis point penalty imposed by the Board in Docket 5701/5724. In fact, the penalty applies to the return on equity ("ROE") only, while rate of return might be interpreted to include other forms of capital, such as preferred stock or debt. For clarity, I will use "ROE" or "return on equity" to refer to this *type* of penalty and "75 bp penalty" to refer to the specific Docket 5701/5724 penalty.

Q. Aside from the HQ-VJO Contract are there any other areas in which CVPS has not prudently managed its power supply portfolio?

A. Yes. One relates to the decision of whether Vermont Yankee ("VY") should have implemented a power uprate in 1999. The other has to do with CVPS's decision that generation equipment maintenance should be considered discretionary, although we are still investigating that area.

Q. Please describe the issue regarding the Vermont Yankee power uprate.

A. The facts of this matter are set out in the testimony of DPS Witness Sherman. In summary, in January, 1999, the VY Board of Directors, under the leadership of CVPS, decided not to pursue a routine, low risk, low cost 25 MW uprate to VY's output that would have been effective by July, 2000, and would have provided power at an incremental cost of about one cent/kWh. Mr. Sherman has determined that this was not a reasonable decision. Under Board doctrine from Docket 5132, if VY's management was imprudent in that decision, then CVPS bears the responsibility as a joint owner. In fact, that Order makes it clear that CVPS would have borne that responsibility even if it had been a minority owner, but in this case, CVPS was the lead owner with a commensurately larger responsibility for the actions of VY's management.

Q. What is the obligation of CVPS with regard to matters such as the uprate?

A. As a regulated public service company, CVPS has an obligation to provide adequate and efficient service to its ratepayers. This means that CVPS has an obligation to plan and implement actions, including but not limited to the acquisition of energy supply resources, that meet the needs of the public at the lowest present value life cycle cost. 30 V.S.A. § 218c(a)(1). A regulated utility is expected to seek out and undertake actions that are beneficial to its

ratepayers and fair to its owners. If such actions are *not* undertaken, the utility has failed to meet its public service responsibilities. *Vt. Electric Plan* at 2-15.

Based on the facts presented above and in Mr. Sherman's testimony, the power uprate is clearly an action that had low risk and exceptionally low cost, would have reduced the life cycle present value cost of meeting the public's need for energy, and would have been beneficial to ratepayers and fair to owners. CVPS failed to meet its public service responsibilities when it rejected the proposed power uprate.

Q. Was that failure an imprudent act?

A. Yes. The proposal presented to the Board of Directors of VYNPC clearly demonstrated that the power uprate was low risk and exceptionally low cost, would have reduced the life cycle present value cost of meeting the need for energy, and would have been beneficial to ratepayers and was fair to owners. Knowing that, a reasonable utility manager, seeking to provide safe and adequate service at least cost, would have proceeded with the power uprate in 1999. This is true even though at the time of the decision in January, 1999, possible opportunities to sell the plant were being pursued, since the uprate would clearly have enhanced the value of the plant, while providing significant benefits before any sale, as well as in the event a sale did not occur. (In fact, the proposed power uprate had a simple payback of only two or three years according to the VYNPC proposal.) Since a reasonable utility manager, mindful of the obligation to provide least cost service, would have chosen to implement the power uprate, it was imprudent not to do so.

Q. What disallowance would be warranted for this imprudent act under traditional rate making?

A. As DPS Witness Sherman testifies, the uprate would have been in place by July, 2000, if approved by the VYNPC Board in January, 1999. He identifies a savings in the Docket

6460 rate year of $3.277 million dollars. The Board may appropriately disallow this amount for imprudence in setting rates in Docket 6460.[5]

Q. Do your conclusions about the VY power uprate have any other implications for this rate case?

A. Yes. CVPS is under a Board Order to "eliminate the excessive power costs imposed on customers by ineffective and improvident management decisions." Order in Docket 5701/5742 of 10/31/94 at 172. The power uprate was a clear opportunity to make substantial progress towards complying with that Order. The Company's failure to do so certainly would justify modifying or increasing the 75 bp penalty imposed in that Docket or imposing a different remedy at this time.

Q. What was the second new area of concern regarding power supply portfolio management?

A. DPS witness Lamont describes in his testimony a passage in an internal CVPS memorandum stating that capital maintenance for generation plant is considered by the Company to be "discretionary." See Exhibit DPS-DFL-3. We are still examining in discovery the particulars of the Company's policy in this regard and its implications. However, on its face, such a policy would seem to be imprudent. If it is so judged, that would provide additional support for reimposing and increasing the ROE penalty, if that were the Board's method of choice for addressing prudence issues in this proceeding, or fashioning a new, different remedy.

Q. If the facts in this case and traditional rate making support the large prudence and used and useful doctrine disallowances you describe above, should the Board actually impose those disallowances in this proceeding.

[5] It is reasonable to assume that that VYNPC and CVPS still have the option of implementing a power uprate and obtaining the benefits from doing so.

A. At this time, I do not believe the Board should do so. Those full prudence and used and useful disallowances, if imposed with finality in this proceeding, would likely result in CVPS recording a very large write down in 2001. This write down would be composed of at least the amount of Docket 6460 prudence and used and useful disallowance for 2001. The Company may also need to recognize in 2001 the amount of any Docket 6120 refunds and would certainly be affected by the cash flow impact of those refunds. In addition, it may be that a final order regarding these matters would mean that there is a loss sufficiently estimable (as that term is used in the Financial Accounting Standards) as to require a write off of future disallowances. In any event, if write downs required in 2001 were larger than the amount Mr. Ross estimates as the limit for retaining an investment grade rating, CVPS's access to capital markets would be impaired. And even if the Board's decision left open the future treatment of the imprudent and non-used and useful Contract costs so open that a life of contract write down was not required, that would leave so much uncertainty about the Company's financial future as to likewise impair CVPS's access to capital markets significantly.

In the case of GMP, the Board found a material disallowance would have had a high probability of triggering insolvency in the short term and relied on that conclusion to support forbearance. Order of 1/23/01 in Docket 6107 at 55 ff. It is not clear whether these events would result in near term insolvency for CVPS. For example, CVPS has proceeds still in hand from its last major financing and is not in such immediate need of credit as GMP was at the end of 2000. However, it seems certain that if there is a full disallowance of the Company's imprudent and non-used and useful Contract costs in this proceeding, CVPS would lose its investment grade bond rating, would be unable to issue debt or equity on favorable terms for years, and would be under steadily increasing financial strain, possibly leading to eventual insolvency. Such financial instability for CVPS would lead to clear costs and uncertain benefits for its customers whether or not it resulted in insolvency. Some of those risks were discussed

by the Board in its Order in Docket 6107 cited above.[6] Because of the risk of bankruptcy and the other negative impacts of financial uncertainty associated a disallowance of the full amounts that could be under the prudence and used and useful tests, it may be fair to ratepayers for the Board to set rates for CVPS that forbear, to some extent, from imposing those full disallowances.

Q. Are you saying that the Board should impose no disallowances of Contract cost?

A. Not at all. To start with, reimposing the 75 bp is the minimum that should be ordered in this case to address the imprudent costs from the Contract. But, if possible, the Board should, instead, fashion a penalty or disallowance that, while less than the full amounts it could impose, is as large as can be imposed while maintaining the Company's financial viability with a reasonable safety margin. In accordance with DPS witness Ross's preliminary conclusion, the disallowances and penalties imposed should be the equivalent of no more than $25,000,000, subject to the caveats and further discovery he recommends. Along with imposing those disallowances or penalties, the Board should (1) make clear that the ordered disallowances or penalties provide finality as to prudence of the Contract and its management to date; (2) state the Contract will then be treated *as if* it were used and useful; (3) impose certain conditions described below, including a recapture provision, a service quality and reliability plan, an earnings cap, and flow through of any ice storm arbitration benefits; and (4) structure the disallowances or penalties in such a way that they can be acknowledged for accounting

[6]While not necessarily determinative in this proceeding, because of the step up provisions in the Contract and other joint action projects of Vermont utilities, such financial distress for CVPS, even if it did not lead directly to rapid insolvency, could do so indirectly. If CVPS loses its investment grade bond rating as a direct result of an order in these proceedings, it is quite possible that GMP's efforts to regain financial stability and access to capital markets could be hampered. If so, it and other utilities might then have difficulty meeting their obligations with negative effects rebounding back onto CVPS, placing it under further stress. And, of course, the benefits and risk protection the Board sought to attain through its forbearance with GMP would be undercut, as well.

purposes as a one-time write down, if possible, to maximize the certainty that the Company will have access to capital markets.

Q. Why is the 75 bp penalty the minimum that should be ordered in this proceeding?

A. In Docket 5701/5724, the Board imposed the 75 bp penalty on CVPS for mismanagement of its power supply. The Board stated the penalty would stay in place "until the Company demonstrates, through tangible results, that it has eliminated the excessive power costs imposed on customers by ineffective and improvident management decisions, or that it is on a reasonable and equitable path towards doing so." Docket No. 5701/5724 Order of 10/31/94 at 172. In Docket 5863, the Board suspended that penalty, stating that "We will leave the power cost penalty in place but suspend the rate effect of that penalty *for the duration of this MOU*." Order of 4/30/96 approving MOU between the DPS and the Company at 5 footnote 4, emph. added. The Docket 5863 MOU was the resolution of a rate case and remains in effect until the rates set by that case are replaced in a subsequent case. Arguably that occurred when temporary rates were implemented in Docket 6120 on January 1, 1999, but in any case, there will be no question that the MOU ends when new permanent rates are set by an order in the present Dockets. Thus, as CVPS has not "eliminated the excessive power costs" or demonstrated "that it is on a reasonable and equitable path towards doing so," and since the Docket 5863 suspension of the penalty expires by its own terms at the end of the MOU in Docket 5863, the penalty should be reimposed as part of any rates set by an order in the present Dockets.

Q. You have recommended that, if possible, the Board fashion a penalty or disallowance of $25,000,000 value instead of reimposing the 75 bp penalty. Please explain why it is fair the Board to do so?

A. Yes. While the Board can and should forbear from imposing the full amount of the potential prudence and used and useful disallowances of Contract costs, it should do more than the minimum out of fairness to rate payers. While this is a case where "traditional rate making methodology may . . . need to yield to other considerations (such as the need to attract capital)," the result must still remain "fair to ratepayers." Order of 1/23/01 in Docket 6107 at 3. Since CVPS's financial situation is nowhere near so dire as GMP's was in Docket 6107, fairness to the ratepayers requires that disallowances, writedowns and other conditions ensure that ratepayers be burdened with no more imprudent or otherwise unrecoverable costs than is necessary to achieve the legitimate objective of forbearance–a financially viable utility capable of providing safe, adequate and efficient service.

To ensure this balanced outcome, the Board should impose disallowances up to the point that it can while still ensuring a financially viable utility. Mr. Ross testifies that a one time write down of $25,000,000 along with the implicit revenue reduction will still result in an investment grade bond rating, provided (1) that it is clear that this is a final disposition of Contract cost issues, and (2) that rates have otherwise been set to allow the Company to earn its normal rate of return under efficient and economic management. The lower end of this range provides a high degree of certainty regarding the bond rating results, including a reasonable margin for error. Therefore, the Board should impose disallowances or penalties consistent with an effective one time write down of $25,000,000, but in doing so should order that this result brings closure to prudence challenges to the Contract's costs as to management actions up to this date and also brings closure to used and useful issues with regard to the Contract.[7] In addition, to ensure fairness to ratepayers, I believe it is necessary to condition this forbearance as described below. And to further buttress the financial stability benefits of such an order, I

[7] I believe that provisions similar to those adopted in the Board's GMP Order, including, specifically, that the Contract will be treated "*as if* it were used and useful" will suffice. Order of 1/23/01 in Docket 6107 at 3 footnote 4, emph. in original.

recommend that any disallowances and penalties be structured in the form of a one time write down of appropriate CVPS accounts to the extent permissible. I believe that doing so will enhance the certainty of the investment community that the order in this proceeding will put the HQ-VJO Contract problem behind us.

Q. What if Board is limited to an ROE penalty for the prudence of the Contract's costs or wishes to rely on such a mechanism for that issue?

A. I have already stated above that reinstating an ROE penalty would be appropriate and explained why the original 75 bp penalty is the minimum that should be imposed. It would be appropriate to impose such an ROE penalty in Docket 6120, commencing with 1/1/99 and with a refund through the date effective date of rates set in Docket 6460, as well as prospectively for rates set in Docket 6460. Furthermore, it would be appropriate to increase the size of the ROE penalty for both Dockets 6120 and 6460, because of the new and independent reasons not related to management of the Contract that CVPS has not properly sought to implement the Board's Order in Docket 5701/5724. However, to achieve the desired outcome of forbearance, any ROE penalty should be structured and sized in a manner similar to the above recommendation. In particular, it should have a present value no larger than $25,000,000, should not include a refund requirement for Docket 6120, should be accompanied by the finality provisions and conditions described above, and should be implemented in such a way that it can be acknowledged for accounting purposes as a one-time write down, if possible.

Q. If the Board does issue an order in these proceedings that leads to a one-time write down as you recommend, what from accounts should the write down be taken?

A. First, the write down should be taken from Regulatory Assets (FERC USOA 182.3) with the exception of the following: Vermont Yankee Energy, Vermont Yankee Capacity,

Millstone Energy, and Millstone Capacity. Any remainder should be taken from the utility plant accounts.

Q. If the Board chooses to forebear and disallow less than the full above market costs of the Contract on prudence or used and useful grounds, are there any conditions or other provisions that should be imposed?

A. Yes, because of that forbearance, the Board should condition its forbearance on certain protections for the rate payers who will be paying more than would otherwise be required under traditional rate making. These conditions should include:

(1) a requirement that any net benefits obtained as a result of the ongoing HQ/VJO Contract arbitration be to flow through to rate payers in an appropriate manner;

(2) a cap on the Company's ROE for a reasonable period of time, say until the end of 2003, with any excess earnings being flowed through to rate payers in an appropriate manner;

(3) a requirement to implement the service quality and reliability plan recommended by DPS witnesses Frankel and Litkovitz and set out in in Exh. DPS-DLF-1;

(4) a mechanism to recapture and flow through to rate payers in an appropriate manner an appropriate, predetermined amount of any premium realized by the Company in any future merger, acquisition or asset sale; and

(5) a requirement that the Company to plan, report and implement a proper ongoing level of investment and expenditure for generation maintenance, including any appropriate catch-up.

Q. Why are these conditions appropriate if the Board exercises forbearance regarding disallowance of imprudent and non-used and useful costs of the Contract?

A. Conditions (1), (2) and (4) are justified by the fact that up to this time and going forward the Board's forbearance has meant that rate payers have borne and will bear substantial costs that would have been disallowed under traditional rate making. While that forbearance is justified and in the public interest, to the extent recommended by the Department, it is certainly appropriate to provide rate payers, as a condition of forbearance, with protections that deliver to them any relief from those excess costs that can be obtained without threatening the financial viability of the Company. Mr. Ross has testified that the Company will be financially viable under the Department's rate recommendation and, in doing so, did not assume any benefits from the ice storm arbitration or earnings above the allowed rate of return. Thus, we may conclude that conditions (1) and (2) will not threaten the Company's financial viability. He has also testified that a recapture mechanism to implement condition (4) would not threaten the Company's financial viability. The justification for imposing condition (3) is given by DPS witnesses Frankel and Litkovitz. Condition (5) is warranted given the concerns raised by the Company's power supply management decisions regarding VY and generation maintenance, as described above.

Q. Are your recommendations in this testimony consistent with the Board's Order in Docket 6107 order?

A. I believe my recommendations are both consistent with that Order and will enhance the desired outcomes of that Order by promoting fairness to ratepayers, financially viable utilities, and safe, adequate and reliable service.

Q. Should the Board make adjustments to any disallowances or penalties to reflect environmental or risk benefits of the Contract?

A. Definitely not.

The first reason is that the Board has already found that the Contract "does not provide risk benefits that are comparable to demand-side management measures." Order of 1/23/01 in Docket 6107 at 39, finding 47. Hence no risk benefits should be accorded to the Contract.

The second reason is that the facts presented by the Department's witnesses in these proceedings clearly demonstrate that the Contract is more likely to have negative environmental impacts than benefits, and that if it does have any environmental benefits, they are quite small. In particular, it is incorrect to compare the air emissions of HQ hydroelectric plants with the air emissions of specific plants that would have been included in a prudent portfolio developed in the early 1990's. Rather, *the total emissions of the region* given the HQ purchase must be compared to the total emissions of the region without the purchase. The record evidence is clear that there was little if any change in the total emissions of the region as a result of the purchase and that any such change is more likely to have been for the worse than for the better.

The third reason is two-fold: these credits were developed in the first instance, to guide resource selection, not for rate making, and even if the Contract did provide some environmental benefits, there is no justification in traditional rate making to adjust any disallowances or penalties to reflect such benefits. Rather, traditional rate making calls for allowing only the cost of the prudent alternative to the Contract. Mr. Chernick has demonstrated in his testimony in this case that reasonable least cost planning assumptions as they would have been developed by a utility manager in the early 1990's based on Board precedent, would have not have resulted in a prudent portfolio noticeably different from that driven by power costs. (Of course, it would have been a smaller portfolio than the Contract purchase due to better recognition of DSM and correct power supply specification, but the types of sources acquired would not have changed materially.) Second, for the same reasons given above, a fully appropriate environmental impact comparison of all of the resources that could have gone into the prudent portfolio through at least 2005 would have shown there would

be virtually no net change to the total regional emissions noticeably. Hence, no resource decisions would have changed over that period and no prudent costs would have changed. (As for the years subsequent to 2005, the avoidable generation resource would have only gotten cleaner as gas combined cycle technology advanced.

Q. Does that conclude your testimony at this time?

A. Yes.